Farm Business Partnerships in British Columbia

Third Edition July, 1983

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FARM BUSINESS PARTNERSHIPS

IN BRITISH COLUMBIA

THIRD EDITION

JULY, 1983

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Preface

A farm business can be organized as a proprietorship, partnership or corporation, and can involve joint ventures, syndicates, or other forms of working agreements. Each method of business organization has specific tax, legal, operational and other requirements.

In recent years, investment per farm in B.C. has increased substantially. This has resulted in additional borrowed funding and has increased the importance of financial management and farm business organizational strategies. Reflecting this and in response to continued requests for information on farm partnerships this third edition of the publication has been updated by Derek J. Fryer, C.A. and is based on the law following passage of Bill C-129 on March 31, 1983. A memorandum on the April 19th, 1983 Budget, presented by the Honourable Marc Lalonde, is appended. (see page 49.)

The original edition was prepared by W.A. Barclay and J. Robertson on a DATE (Demonstration of Agriculture Technology and Economics) contract. The second edition involved a major update in 1981 by Don Piche, C.A.

This publication provides general information on Farm Business Partnerships in B.C. and will be of interest to many farmers. A second publication entitled "Farm Business Partnerships in B.C. - Standard Clauses for Farm Partnership Agreements" will be of interest to those farmers who decide to pursue a farm partnership in more detail. Other Ministry publications which may assist in the tax planning area include: "Taxation and the B.C. Farmer", "Farm Business Corporations" and "Estate Planning".

When determining the most appropriate farm business structure, each farm situation is a special study which requires investigation of the type and value of assets, debt and income levels and the operational and estate planning goals of the farm family. This publication outlines some of the information and analysis that should occur before a professional advisor is approached for discussions of your specific situation. When you have a general understanding of partnerships and have gathered the required financial information, you should discuss your proposal with a farm management advisor, accountant and a legal advisor. Once the most appropriate form of business organization has been selected, the decision should be finalized in the appropriate written form.

Discussion of legal aspects in this publication is intended for informational purposes only and because of complexities and the importance of farm business partnerships in British Columbia, the reader should not be bound solely by the information contained herein. In other words, legal steps should not be taken without proper consultation with your lawyer.

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CHAPTER 1

CHOOSING A WAY TO ORGANIZE AND CARRY ON A FARMING BUSINESS

The way in which a business is organized will often have a considerable bearing on its ultimate success or failure. For example, a corner grocery store could not be successfully operated as a public company whose shares were traded on the Vancouver Stock Exchange. Nor could a large public company in the food business be organized and operated on principles which properly apply to a corner grocery store. In other words, for every size and kind of business undertaking, including a farming business, there is some optimum form of business organization which should be employed. The objective, of course, is to ensure that the owner or owners of the business can maximize the personal and financial goals they have set themselves with a minimum of difficulty. For B.C. farmers, there will be different answers for different situations since every farming business is unique, in at least some respects. Nevertheless, there are some basic questions, common to all business activities, which need to be reviewed carefully before an intelligent decision can be made as to how to set up a new farming business or reorganize an existing one.

Some of the basic issues are as follows:

a) The need for permanence and stability for the business operation

In this regard it is useful to contrast the unincorporated farm business with an incorporated farm. A corporation gives an element of permanence to a business which is not available if the business is carried on in the personal name of the farmer. Consider what happens to the farm corporation at the time of the farmer's death. The farm corporation will simply have a new shareholder - the farmer's estate or perhaps his widow. The farm corporation can carry on, just as it did before, provided that it can find a competent farm manager to replace the farmer who has died. All of the farm's assets, its debt financing and the conduct of its operations can remain quite unaffected by the death of the principal shareholder. The exact name under which the farm business was carried on would also continue.

The same principle would apply if some or all of the shares of the farm corporation were sold to a third party such as a son or daughter.

Corporations do not die unless they are wound-up and can theoretically continue in business indefinitely.

b) Financing the farm operations

The manner in which farm credit is obtainable may depend to some extent on the way in which the farming business is organized. For example, in British Columbia in recent years we have sometimes seen lending institutions put pressure on farmers to incorporate so that the lender can secure his loans by way of a debenture. As a further example, an amendment to the Income Tax Act was made in 1979 which enabled corporations to issue an attractive financing instrument

called a small business development bond ("S.B.D.B."). However, incorporating for financing reasons alone may not be an appropriate decision in all circumstances.

While financing needs are undeniably very important, long-term tax planning is also a major concern. Ideally, with good judgement, both of these goals can be achieved.

c) Transferring of assets between generations

Of all the reasons for giving careful thought to the business organization this particular one is critical to the farm community. For a family farming business to remain intact in the hands of a son or daughter, a workable transition from parent to child must be provided for. This transfer will have personal and emotional implications and, in many situations, will require considerable prudence because control of the family's assets will be passing from an older, experienced person to a son or daughter who are less experienced in the business.

As we shall see, family partnership arrangements may be one type of business organization which can work especially well to provide a solution to the age-old problem of transferring a farm operation from one generation to the next. They can provide a more complete rollover than can be obtained if the father carries on his business as a sole proprietorship.

A well-written article on the human factors involved in family business operations is reproduced in Appendix I.

d) Keeping income taxes to a minimum during the operation of the farm and at date of death

Almost as close to the heart of every farmer as having a good year on the farm is his strong desire to avoid having to pay too much income tax on his profits!

It has been our experience that the desire to reduce income taxes is probably the single most powerful motive which influences the way in which a farmer organizes his business. It should be emphasized that there is nothing immoral about planning one's business affairs to keep income taxes to a minimum provided the letter of the law is observed. If the tax authorities feel that abuse is occurring, they normally act very quickly to recommend changes to the law. When proper and legitimate tax planning can minimize, defer or eliminate income taxes, it should be used. From the point of view of cash flow, income tax is an operating expense, just like any other. On reflection, however, that is not quite true because income tax is not a deductible expense!

e) Ease of setting up, operating, or dissolving the farm business

A complicated business organization, while it may have income tax advantages or provide a way to transfer the farm between generations, may involve additional costs such as legal, accounting and similar consulting fees.

There is a lot to be said for simplicity but there is no point in being simple-minded. If a simple form of business organization is used, it should be because the farmer has made a conscious decision to do so. He should have reviewed all of the advantages and disadvantages of partnerships, corporations, and proprietorships and with professional help should have decided which type of organization is appropriate in light of his particular circumstances.

Sometimes a few complexities in business organization and operations are necessary but in those circumstances, the advantages obtained should always outweigh the costs and complications which result from that complexity.

In 1978 the British Columbia Family Relations Act was enacted into law which has far reaching legal implications for British Columbians. One intent of the new law was to ensure that, with respect to matrimonial property, there is an equitable distribution of family assets in the event of separation or marital discord. The nature of this Act is far-reaching and complex so individuals should seek counsel from a lawyer regarding the Act's application in the particular circumstances at hand.

Because of the Family Relations Act, a person contemplating the formation of a family farm partnership who is concerned about the stability of his marriage, should seek legal advice. Contentious issues may arise in the future with respect to the legal interest which the other spouse may have in the assets to be purchased by the farm partnership and in the interest in the farm partnership itself.

CHAPTER 2

WHAT IS A PARTNERSHIP?

General

Carrying on business in partnership is a well-established style of business organization. In fact, the partnership has been a feature of commercial activity in western society much longer than the limited liability corporation, a relatively recent development.

A partnership is very easy to set up. Generally, it will come into existence when two or more people pool their resources, whether in the form of capital, labour or both, and carry on together a profit-motivated business activity. The manner in which profits or losses are shared, capital is contributed or withdrawn, and management tasks are assigned and performed are completely flexible.

The formalities required for establishing and maintaining corporations, such as the registration of Articles of Association, election of directors, appointment of officers, holding of annual general meetings, etc. are not required for a partnership. This is not to say that formal arrangements, per se, should not exist. In many cases, if not all, it will be desirable to have at least a simple, written agreement which sets forth the mutual understanding of the business relationship that exists between the partners. Throughout this booklet, the need for a written agreement of this kind will be stressed.

How the law defines a partnership

British Columbia, as do other provinces in Canada, has specific legislation which governs partnerships in the province.

For legal purposes, the word "partnership" has a very broad definition. It is defined as:

> "the relationship which subsists between persons carrying on business in common with a view of profit"

A series of qualifications, however, narrows the definition somewhat. Two of the most important of these are:

> "In determining whether a partnership does or does not exist, regard shall be had to the following rules:
>
> a) Joint tenancy, tenancy in common, joint property, common property, or part ownership does not of itself create a partnership as to anything so held or owned, whether the tenants or owners do or do not share any profits made by the use thereof:

b) The sharing of gross returns does not of itself create a partnership, whether the persons sharing such returns have or have not a joint or common right or interest in any property from which or from the use of which the returns are devised."

It should also be noted that partitions between spouses under the B.C. Family Relations Act cannot of themselves create partnerships.

It is very important that people who are either engaged in a farming partnership, or contemplating such an arrangement, be aware that there are certain specific rules in the B.C. Partnership Act which will apply to all partnerships if no express agreement exists to the contrary.

Some Examples

(a) All partners have the right to share equally in the profits of the partnership.

(b) On the death or bankruptcy of a partner, a partnership of two partners is dissolved; and subject to agreement between the partners, a partnership of more than two partners is dissolved as between the bankrupt or dead partner and other partners. Also, a partnership is dissolved, if entered into for an undefined time, by any partner giving notice to the other or others of his intention to dissolve the partnership. This could give rise to unexpected taxation of capital gains or recapture of capital cost allowances.

Both of these rules can be varied by a written agreement between the partners. In the first instance, for example, the partners could agree to a specific formula for the sharing of profits. In the second case, the partners would normally wish to agree that the partnership business continues even though one of the partners in a partnership with more than two partners gives notice of his intention to dissolve the partnership or intends to withdraw. As already noted, dissolution of a partnership can have some adverse tax consequences if it is not properly planned.

For these reasons alone, it is important that every partnership have at least a simple written agreement, signed by each of the business partners.

How the Income Tax Act defines a partnership

Curiously enough, the Canadian Income Tax Act makes no attempt to define the term "partnership". The Act contains some very complex income tax rules which apply to partnerships but does not give any guidance as to whether a partnership exists in particular situations.

In the absence of specific direction in the Income Tax Act, it is necessary to fall back on the ordinary legal meaning of a partnership in each particular province.

Revenue Canada has given some general guidelines as to whether or not they will consider a partnership to exist in certain situations in Interpretation Bulletin IT-90.

An excellent review of this matter from a legal point of view, is contained in a booklet entitled "The Business of Defining Partnership under the Canadian Income Tax Act" by Howard J. Kellough and published by CCH Canadian Limited.

In summary, every situation has to be reviewed on the basis of its own facts so that a judgement can be made as to whether a partnership exists for legal purposes. If a legal partnership does exist, then the various special income tax rules concerning partnerships will come into play.

If a partnership does not exist for legal purposes, however, then none of the partnership rules of the Income Tax Act will be applicable.

CHAPTER 3

CAN JOINT OPERATIONS OR OWNERSHIP ARRANGEMENTS EXIST WHICH ARE NOT PARTNERSHIPS?

Some common types of non-partnerships

As indicated in the preceding chapter, there are certain forms of multiple ownership of property and certain jointly conducted business activities which are not considered to be partnerships for legal or income tax purposes. They may be called syndicates, joint ventures, or co-ownerships or joint ownerships of property.

A common example is a joint ownership of a rental property under which two or more people have undivided interests as tenants-in-common. Another example is joint tenancy, such as joint ownership of a home by a husband and wife. Generally, a partnership does not exist in these situations. If revenue is earned from these arrangements, each person has to account for his share of the income and the related expenses.

Business Agreements

Some authorities consider that two or more people may be able to enter into a business agreement to pool their resources and still avoid having the status of a partnership for income tax purposes.

The discussion of that particular subject is beyond the scope of this publication, since we will at all times assume that two or more persons who carry on a farming business together are in partnership. The legal and income tax interpretations of that term will be considered to apply and as a result the farming business will be subject to all the income tax rules governing partnerships.

It is always important to keep in mind that the existence of a partnership depends on all the facts and circumstances of a particular situation, not on the clever wording of the clauses which happen to be written into a particular agreement.

A standard clause in a non-partnership agreement, such as a syndicate of co-owners, for example, might be the following:

> "The parties thereto hereby expressly deny any intention or Agreement to be or become partners or to enter into any partnership or, to be or become agents, one for the other, for any reason or to any extent whatsoever."

If the facts indicate otherwise, however, a partnership may still exist, despite all attempts to deny it in the agreement.

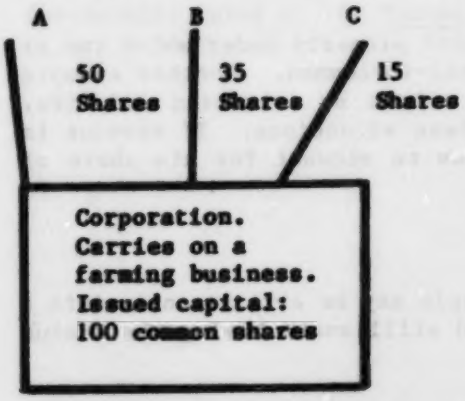
CHAPTER 4

FARMING CORPORATIONS AND FARMING PARTNERSHIPS:

A QUICK COMPARISON FROM AN INCOME TAX STANDPOINT

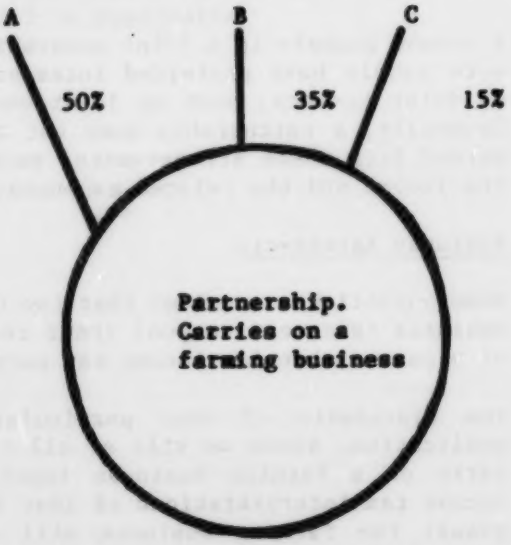
Sometimes a picture is worth a thousand words. We will try the picture first and then let the thousand words follow.

Shareholders:
(each owns shares)



- Limitation of legal liability
- Corporation pays income tax and files tax return
- Shareholders pay personal income tax on dividends, interest, salaries or directors' fees as they are received from the corporation
- Taxation of income at the shareholder level can be deferred

Partners:
(each owns a partnership interest)



- No limitation of legal liability
- Partnership doesn't pay income tax and doesn't file a tax return
- Partners pay personal income tax on their share of partnership income as it is earned by the partnership
- Taxation of income at the partner level cannot be deferred

A. FARM CORPORATIONS

1. What each shareholder owns

Each shareholder owns a capital property, being shares in the company, on which he may receive investment income in the form of taxable dividends. Dividends are paid only if and when the company's directors declare them to be payable. Dividends are not a deductible expense to the company for income tax purposes since they are paid out of the company's after-tax earnings. A shareholder who loans money to the company could also receive interest income on his loan. Such interest is generally deductible by the company and is taxable in the hands of the shareholder when it is received.* It is quite common for a shareholder to put a portion of his money into the company in the form of share capital and the balance by way of a shareholder's loan.

2. Shareholders may also be employees of the company

Some or all of the shareholders may also be employees of the company. Employees include corporate directors and company officers to whom salaries, director's fees or other such remuneration may be paid. Such amounts are deductible to the corporation for income tax purposes and taxable as employment income to the employee receiving them.

3. Sale of shares by a shareholder

A shareholder may sell his shares to a third party, but this transaction normally requires the consent of the other shareholders. If he receives proceeds in excess of the total of his adjusted cost base in the shares and the selling expenses he has to pay, he will be treated as having realized a capital gain for tax purposes. One half of this gain will be taxable in the year the shares are sold.

If the proceeds from the sale are payable over a number of years, the shareholder will be able to claim reserves for tax purposes which will have the effect of spreading the tax cost over the period during which the proceeds are collected.+

If proceeds from sale of the shares are less than the adjusted cost base of those shares, a capital loss may arise. One half of such a loss is deductible for income tax purposes, within certain limits. Allowable capital losses of individual shareholders which are not usable in a particular year may be carried back to the previous taxation year or carried forward to future years, within prescribed limits. A careful review must be made to

* The Income Tax Act has been amended to require individuals to include in their incomes every three years the interest that has accrued but not been paid.

+ The Income Tax Act now contains rules which limit the number of years in which a reserve may be claimed.

determine the amount of any allowable capital loss, the type of income against which it can be applied and the length of time it can be carried forward.

4. Income tax levied on the corporation

Each corporation is liable for income tax on its taxable income for the year and must file a Form T2 tax return every year. The effective rate of corporate tax in B.C. for most incorporated farming operations is 23% on the first $200,000 of taxable income from farming sources and 52% on other income. In 1983 and 1984 a surtax applies to income taxed at the top corporate rate which increases the effective rates to 54% and 53% respectively.

The $200,000 limit applying to the amount of income that can be taxed each year at the low rate must be shared by companies which are associated for income tax purposes. In addition, the ability of a corporation to be taxed at the low rate disappears when its accumulated business earnings, and the earnings of corporations associated with it, reach $1,000,000.

In 1983, the government introduced a new tax on corporations which pay dividends out of profits that have been taxed at the low rate of 23%. This tax is computed at the rate of 12 1/2% of the dividends paid and applies to dividends paid out of profits earned in years commencing after 1982. This new tax should be looked upon as a second level of corporate income tax that is payable by the corporation only when profits are distributed to shareholders. This second level of tax effectively increases the corporate rate from 23% to 31%.

5. Income tax levied on the shareholders

When an individual shareholder receives a taxable dividend from a Canadian corporation, special rules apply. The following illustration shows how the system works:

Cash amount of dividend received	$ 1,000
Add: 1/2 gross-up amount	500
Taxable amount of dividend to be reported on the farmer's tax return	$ 1,500

Even though the farmer received only $1,000 in cash, he is required to report and pay tax on $1,500. On the surface that may seem to be unjust but when the farmer's dividend tax credit is taken into account the net tax cost is lower than it would be on other forms of income. This is illustrated below on the assumption that our farmer is a resident of B.C. and receives the dividend in 1983:

Taxable income	$ 1,500
Federal income tax at the shareholder's marginal tax rate - 30% (note)	450
Less: Federal dividend tax credit (34% of actual dividend)	340
Basic federal income tax	110
B.C. income tax (44% x basic federal income tax)	48
Total Income Tax on Dividend	$ 158

Note

It is assumed that the shareholder has other taxable income in the range of $33,012 to $56,592.

It is interesting to express the amount of tax as a percentage of the actual dividend received and to compare this percentage with the rate of tax that would have applied had the dividend been ordinary income:

Percentage tax on dividend (158/1,000)	= 15.8%
Percentage tax that would apply to other income (1.44 x 30%)	= 42.2%

It should be noted that the foregoing calculations ignore the B.C. surtax introduced in 1981.

From the above example, it is clear that the net income tax cost of receiving dividends is much lower than the tax cost of receiving ordinary income.

6. How dividends are determined and paid

The directors of the company normally have the authority to determine the amount of any dividend which is to be paid. Ordinarily, the amount of the dividend must be within the total of the company's retained earnings and the profits for the year in which the dividends are to be paid. Dividends paid on a particular class of shares must be paid pro-rata to the various shareholders of that class.

If the company's Articles permit, dividends may be paid on one outstanding class of shares without being paid on other outstanding classes. This flexibility must be specifically planned for, either at the time that the company is set up or as a result of the reorganization of its capital. Care must be exercised in determining the situations in which this type of share structure might be appropriate.

7. Salaries

Any individual who provides his services to the corporation may receive income from the company in the form of salary. A salary paid to a shareholder-manager of a farm corporation is deductible by the corporation and is taxable as employment income to the shareholder. The salary is subject to the normal withholdings for personal income tax and Canada Pension Plan Contributions, which must be remitted to Revenue Canada within 15 days after the end of the month in which the salary is paid. A withholding for unemployment insurance will usually not be required. A T4 slip must be prepared by February 28 of the following year.

The amount of salary should not be unreasonable in the light of the value of services provided to the company. However, in practice, there is considerable flexibility in this regard.

8. Remuneration of a spouse

A farm corporation can usually pay a salary to the farmer's wife in respect of her work on the farm or for the accounting, secretarial and administrative services she provides. The salary is deductible to the company and taxable as employment income in the hands of the spouse who receives it.

Since January 1, 1980, sole proprietorships and partnerships have been able to deduct salaries paid to the wife of a proprietor or partner.

Withdrawals ("drawings") of cash by a partner which reduce his capital account are not generally subject to income tax in the year they are withdrawn.

It is important to note that profit-sharing ratios and capital contribution ratios in a partnership need not be related to each other.

B. FARM PARTNERSHIPS

1. No income tax is levied on the partnership

No income tax is levied on the partnership and it is not required to file an income tax return as a separate entity. However, the net income for tax purposes of the partnership must be calculated as if the partnership were a separate person who was subject to tax. Usually a financial statement for the partnership's business as a whole is prepared and each partner files a copy of it with his own income tax return.

2. Income tax is levied on the individual partners

Each member of the partnership must declare and pay income tax on his share of the partnership income that has been earned in the partner's taxation year. For individual partners, income tax would apply at individual tax rates and the partnership income would be considered to be income from farming for purposes of the block averaging rules for farmers.

A corporate partner, i.e., a member of the partnership that was a corporation, would be liable for income tax at corporate tax rates on its share of the partnership income. Such income would retain its status as active business income for purposes of the 23% effective rate of income tax. The amount of partnership income that can be taxed at this rate in the returns of the corporate partners cannot, in total, exceed $200,000 each year.

3. How the partnership profits are shared

Generally, profits may be shared in any manner agreed on by the partners. The profit-sharing ratio need not be embodied in a written agreement or be pre-determined. However, if there is no agreement, whether expressed or implied, the Partnership Act states that profits are to be shared equally. Note also that the Minister of National Revenue has discretionary power to reallocate partnership profits where the allocation agreed to by the partners is unreasonable. In arm's length partnerships this is unlikely to be a problem but in husband and wife situations it might be if profits are not shared on a basis that is reasonable in relation to the contribution by each spouse.

4. How capital is contributed and withdrawn

Each partner will normally advance cash or contribute assets to the partnership business. Cash would be deposited in a bank account established in the partnership's name. Assets, where possible, would be registered or recorded in the name of the partnership. The ratio of capital contributions between partners is totally flexible, and can be varied by agreement by the partners at any time.

5. Contribution of capital in the form of assets

Under a special subsection of the Income Tax Act, property of virtually any kind may be contributed to a Canadian partnership by a partner at a special transfer price for tax purposes. The price can be set at any amount between the actual consideration received for the property, other than a partnership interest, and the fair market value of the property.

This is a very important rule. It allows assets which have increased in value to be transferred to a partnership without incurring tax on the accrued gains. A thorough review of this rule is contained in Chapter 11.

6. What the partner owns: An interest in the partnership

An interest in a partnership is a capital property just like the shares in a corporation. An interest in a partnership can be bought or sold and a capital gain or capital loss may result. A capital gain will result if the proceeds of disposition exceed the total of the adjusted cost base and the selling expenses. A capital loss will result if the adjusted cost base and selling expenses exceed the proceeds.

If the proceeds from the sale of a partnership interest are payable over a number of years, the partner will be able to claim reserves for tax purposes which will have the effect of spreading the tax cost over the period during which the proceeds are collected. Again, the number of years in which these reserves may be claimed is limited.

7. How the adjusted cost base (ACB) of a partnership interest is determined

The ACB is generally determined by the following formula:

ADD:

a) the actual cost incurred to acquire the partnership interest, when a partnership interest is purchased;

b) the capital contributions made to the partnership by the partner; and

c) the share of income of the partnership for the years ending prior to the date the ACB is being determined; and

DEDUCT:

a) the partner's drawings from the partnership up to the date of the calculation of the ACB; and

b) the partner's share of any losses incurred by the partnership for the year ending prior to the date the ACB is being determined.

The above formula will cover the majority of situations. Certain other adjustments, of a special nature, may be made to the ACB calculation as well. Some of these are:

a) The partner's share of the non-taxable portion of the proceeds on sale of goodwill items such as milk quota or poultry quota;

b) The partner's share of the non-taxable portion of any capital gains realized by the partnership;

c) The partner's share of any capital dividends received;

d) The partner's share of any life insurance proceeds received by the partnership;

e) The partner's share of investment tax credits earned by the partnership which are deducted by the partner in computing his taxes payable.

There are also a variety of rather technical adjustments. See Revenue Canada Interpretation Bulletin No. IT-353R2 for details.

8. What happens if a partner's drawings exceed the additions to the ACB?

If an ACB calculation gives a negative result, i.e. the total of the partners withdrawals, share of losses and other deductions exceed all additions to the cost base, there are usually no adverse tax implications. This is not the case with other kinds of capital property. An interest in a partnership is a unique asset in that a negative ACB will not cause a taxable capital gain to be realized as long as the taxpayer is a member of the partnership.

9. What happens if a partner borrows money to buy a partnership interest?

The interest expense will generally be deductible for income tax purposes with the amount, for an individual partner, being determined on a calendar year basis rather than on the fiscal period of the partnership.

10. Are other expenses incurred personally by a partner which relate to earning his partnership income deductible?

Yes. Such expenses may be deducted either on a calendar year basis or on the basis of the fiscal period of the partnership. The choice of method is available to the taxpayer.

11. No deduction from ACB required for partnership expenses incurred personally

It is important to note that interest expense incurred to borrow money to contribute to a partnership will not be deducted from the ACB of the partnership interest. Nor will other expenses personally incurred for business purposes, such as those outlined in item 10 above.

12. What happens if the partnership incurs expenses on a partner's behalf which are not deductible for income tax purposes?

Expenses of this nature, incurred by the partnership on the partner's behalf, but not deductible for income tax purposes, will be treated as drawings which will reduce the ACB of the partnership interest.

Summary

After one picture and several thousand words, you should now have a basic understanding of the major differences between a farm corporation and a farm partnership.

CHAPTER 5

CALCULATION OF INCOME FOR TAX PURPOSES FROM A FARMING PARTNERSHIP

The main concept to grasp in understanding how a partnership is treated for income tax purposes is to remember that a partnership does not file an income tax return and the partnership entity itself is not subject to income tax. However, each partnership must calculate its net income as if it were a separate person that was subject to income tax.

After this income has been calculated, each member of the partnership must include his share of the income or loss in his own income tax return for the taxation year in which the partnership's fiscal period ends. A partnership always determines its annual income as of the last day of the fiscal year of the partnership. This concept may be illustrated as follows. An individual filing his 1983 income tax return includes in that return his income from a partnership which had a year-end of January 31, 1983. The January 31, 1983 financial statement of the partnership will include eleven month's income generated in 1982 and one month's income generated in 1983. However, all such income is reportable for tax purposes in 1983. The income earned by the partnership in the period February 1, 1983 to December 31, 1983 will be taxed in the partners' 1984 income tax returns.

The foregoing rules illustrate the potential for obtaining a substantial tax deferral where a partnership is newly established. This advantage can be further extended if the partners are corporations.

Let us consider now some of the detailed rules for calculating income from a partnership.

A partnership which carries on a farming business, as that term is defined in the Income Tax Act, may determine its net income for income tax purposes by using the cash method. Reference should be made to Chapter 3 of "Taxation and the B.C. Farmer" for details on the use of the cash method.

In almost all farming businesses, use of the cash method for tax purposes will be preferable to the accrual method, even though the latter method may be required for most other kinds of business income.

Capital cost allowance

Any depreciable property owned by the partnership will give rise to a claim for capital cost allowance at the partnership level. If the fiscal period of the partnership is less than 365 days the amount that can be claimed must be pro-rated based on the number of actual days in the fiscal period. In the year in which the depreciable property is acquired the capital cost allowance claim is ordinarily computed at one-half of the rates that will apply in future years.

Special consideration will apply to those old system partnerships which owned depreciable property at V-day. Some rather complicated transitional tax rules will apply to them.

Partnerships which own straight line (Part XVII) depreciable property will be subject to some complicated transitional rules as well. For purposes of this article, we have assumed that in all cases we are dealing with a new system partnership (one established after 1971) and we have ignored the existence of assets depreciated on a straight-line basis.

Aside from the transition from the old tax system, the income tax treatment of depreciable assets owned by a partnership is relatively straight forward.

Investment tax credit

Farming partnerships which acquire certain new depreciable property after June 23, 1975 are entitled to a special "investment tax credit" which may be applied against federal income taxes payable by the partners. The amount of the credit will vary depending upon the geographical location of the farming operations. In certain parts of B.C. the credit will be computed at 7% of the cost of property acquired and in other parts of the province, the rate will be 10%. Reference should be made to Revenue Canada Information Circular No. 78-4R for details as to which parts of the province qualify for the higher rate. Effective November 16, 1978 there is also a 7% investment tax credit for qualifying transportation equipment.

The credit applies to certain machinery, equipment and buildings. The prescribed uses to which qualifying property must be put are such that most new machinery, equipment and buildings which a farmer acquires will qualify for the investment tax credit. A car or truck designed for use on highways or streets (whether or not it is actually used for such a purpose) does not qualify nor does the farmer's house.

Where an investment tax credit is earned on depreciable assets acquired by a partnership, the amount of the credit must be allocated to each partner in accordance with his share of the partnership income. The allocation of the investment tax credit is made to the partners at the end of each fiscal period. If in a particular year, a partner is not able to utilize the credit allocated to him for that year the credit should be carried forward on Form T2038 which is filed with his personal income tax return. The credit deducted by a partner in computing his income taxes payable will reduce the adjusted cost base of his interest in the partnership. The capital cost of each property acquired by the partnership must be reduced by the investment tax credit claimed in respect of that property. Thus, if a 7% investment tax credit is claimed, only 93% of the original capital cost of the asset can be depreciated for tax purposes.

Government rights

Government rights such as milk quota or poultry quota acquired after 1971 are written off in a manner similar to that which applies for depreciable assets. Where quota is acquired by a partnership, the partnership must determine the amount which is deductible and claim the deduction in arriving at its net income. Unlike the rules for capital cost allowance, however, no

proration for a short fiscal period need be applied where a partnership is writing off quota for a period which is less than 365 days.

Income from a farming source

Where a partnership operates a business and some or all of the partners are not full-time farmers, the restrictive rules which apply to hobby farmers may be applicable. It should be noted that these rules apply to the partners (whether individuals or corporations,) and do not have any application at the partnership level. As a consequence, it would not be unusual in a particular partnership situation to find that one or more partners are treated as hobby farmers while others are treated as full-time farmers. For this and all other purposes, the character of the income of the partnership to each of the member partners will retain its identity as income from a farming business.

Disposition of a capital property owned by a partnership

Any capital gain or loss realized on the disposition of a capital property owned by a partnership must be allocated to the members of the partnership. The gain or loss is determined at the partnership level in the normal manner and one-half thereof (the taxable portion) is allocated between the partners. The taxable capital gain or allowable capital loss allocated to each partner is included in his tax return as if he had realized it in his own right. Special rules apply if a partnership disposes of a listed personal property or a personal-use property. We have not dealt with those items here as they are not commonly owned by farming partnerships.

Inventory allowance

A farmer on the accrual basis of accounting may claim a deduction from income in the amount of 3% of the ending inventory of the preceding year of certain property held for sale. In a partnership situation, the partnership should deduct any relevant amounts in the calculation of its income before allocation to partners.

CHAPTER 6

FAMILY PARTNERSHIPS

Special tax rules applicable to non-arm's length transactions

The partnership form of business organization which has been described in the preceding sections need not necessarily be restricted to unrelated people who are dealing with each other purely as business partners. On the contrary, in the farming community, partnerships will frequently be formed between family members.

In a situation where one or more related persons enter into a partnership agreement, certain income tax complications may arise. Related persons are not considered to deal at arm's length, for example. While the rules can get quite complicated, it is sufficent for readers to be aware that related persons include:

parents	grandparents
children	grandchildren
brothers	great-grandchildren
sisters	brothers-in-law
sisters-in-law	sons-in-law
daughters-in-law	

An uncle or an aunt, a niece or a nephew, or a cousin, on the other hand, would not normally be a related person for income tax purposes.

Special tax rules may apply to non-arm's length transactions. Probably the most important rule which has to be observed when related or non-arm's length parties have financial dealings with each other is that all the transactions be conducted at fair market value. As long as this general rule is observed, most problems can be avoided. There may be specific exceptions, of course, such as the rule which specifically permits a transfer of farm property at less than fair market value from father to son.

The foregoing comments do not apply to financial transactions between a husband and wife. In these situations the income attribution rules and special rules regarding capital gains and recapture of depreciation have to be observed. These will be discussed further in the section dealing with husband and wife partnerships.

Financial dealings with children under age 18 are also the subject of special rules.

Parent-Child Partnerships

Partnerships between father and son are probably the most common type of partnership arrangement presently found in the farming community. In many cases, there are partnerships existing in fact which are not the subject of a written agreement between father and son. They have simply developed as a result of carrying on the business together. Once again, it should be emphasized that a partnership does not necessarily have to have a written agreement to exist for legal and tax purposes. Nevertheless, to avoid problems even the simplest written agreement will, in most cases, be very desirable.

A father-son partnership is very easy to establish and is also one of the most natural ways to involve a son in the future business so that he will eventually take over the farm completely. Under the existing income tax rules, where father and son operate a farming business in partnership at the time of the father's death, the father will be able to leave the farmland, buildings and all other farming assets to the son if these properties are owned by the partnership. In order for this "rollover" to apply the business must be a family farm partnership, as defined. A family farm partnership is one where substantially all the assets are used in a farming business and the father, his spouse or child are actively involved.

A more common situation might be where father operates an "income" partnership with one or more of his children, while continuing to own the land and buildings and possibly farm machinery personally, and at the time of his retirement he leases those assets to a partnership or proprietorship carried on by his children. In that situation, Revenue Canada's present administrative practice is to allow the farm rollover to apply even though, strictly speaking, the assets are being used to earn rental income rather than income from a farming business. One of the drawbacks of this leasing arrangement is that farm buildings which would otherwise be classified as class 6 property and be written off for tax purposes at the rate of 10% per annum may become class 3 property which is depreciated at only 5% per annum.

It should be noted that where the father and son were both active in operating the farm business at the time of the father's death, any accrued capital gain on the son's interest in the partnership could be "rolled over" under the rules which permit a partnership to continue as a sole proprietorship. Certain rules have to be met for this rollover to apply.

In family farming partnerships a parent can enter into a partnership arrangement with his children and transfer his interest to them at death on a rollover basis. He can also transfer all or a part of his interest to his children on a rollover basis during his lifetime. Care must be taken, however, in the manner the transaction is carried out.

Husband-Wife Partnerships

For many years there was an income tax deterrent to the establishment of business partnerships between a husband and wife. If a husband and wife were partners in a business the Income Tax Act gave the Minister of National Revenue a discretionary power to tax the entire income of the partnership in the hands of one of the spouses, usually the husband. This tax rule applied in spite of the fact that a legally valid partnership created under B.C. law might have stated that the husband and wife were to share profits equally.

The rule was repealed effective January 1, 1980, the effective date on which the rule against the deduction of salaries paid to spouses of proprietors or partners was also repealed. It should be noted, however, that Revenue Canada still has the ability to challenge the allocation of income between the husband and wife, or between any partners, if the allocation is unreasonable.

In situations where one spouse (say, the husband) is considerably more active in the farming business than his wife and there is no partnership agreement, it can be difficult to determine whether a partnership actually exists. The basic question that has to be answered in these situations is whether the involvement of the wife arises because of her commitment to the family or because of her intention to enter into a contractual arrangement with her husband. If the wife's activities go beyond what might be expected of the housewife or mother, there may be a partnership between the spouses even though there is not a partnership agreement.

Clearly, in a situation where all of the farm property is owned by the husband, and the wife's involvement is limited to visiting the bank and maintaining the accounting records, it is unlikely that a partnership exists. On the other hand, if the wife owns an interest in some or all of the property and works on the farm on a regular basis, Revenue Canada would probably assume that a partnership exists.

It should be noted that the mere pooling of resources will not by itself constitute a partnership. There has to be an intention to enter into a business relationship.

While not conclusive, the existence of the following factors will generally lead to a presumption that a partnership exists:

(1) use of a joint bank account to pay farm expenses;

(2) co-ownership of farm property;

(3) ongoing involvement of the wife in farm chores and business decisions; and

(4) existence of a partnership agreement.

The absence of a partnership agreement will not necessarily be fatal but it will make it easier to demonstrate to Revenue Canada that there is an intention to establish a contractual arrangement outside of the marriage.

CHAPTER 7

PARTNERSHIP AGREEMENTS: THEY SHOULD BE MORE THAN JUST A HANDSHAKE

General

It has been our experience that many partnerships, and other forms of joint operation of farming enterprises, are conducted on an ad hoc basis without any formal, written arrangements. Why bother with complicated and costly legal and accounting advice when all partners understand each other? In many cases, day to day operations can be conducted in this manner without serious difficulties provided there is a strong element of mutual trust and a clear understanding of the rights and duties of the parties involved. But even if informal partnerships of this kind may appear to work well on the surface, there are some very compelling reasons why the details of the partnership arrangements should be committed to writing. In situations where there is not a strong level of trust, a family bond or mutual co-operation then the reasons for a written agreement are even more important.

Summarized below are some of the reasons why partnerships should have a written partnership agreement. Farmers who want to find out what type of clauses are generally included in these agreements should review the publication, "Farm Business Partnerships in B.C. - Standard Clauses for Farm Partnership Agreements" which is published by the Ministry of Agriculture and Food.

Legal Aspects

Under B.C. Law, a partnership business which does not have a written agreement will, by default, be governed by the terms of the B.C. Partnership Act. While the operation of this statute may be fine in many respects, there are certain parts of the law which may well be quite contrary to the real intentions of the members of the partnership. For example, the B.C. Partnership Act provides that all members of the partnership are to share equally in the profits of the business. Any variation of this profit sharing arrangement must be agreed to in writing by the members of the partnership. Another extremely important legal point concerns the circumstances under which a partnership will be considered to be dissolved. The simple act of bringing in a new partner or having an existing partner depart will automatically, by operation of law, cause the existing partnership to be dissolved. That fact will have an immediate, unattractive income tax result. For tax purposes the partnership will suddenly have a year end as of the date of dissolution and a deemed realization at fair market value of its assets could occur. Once again, if the members of the partnership wish to have the partnership continue in existence at the time a new partner is admitted or a partner leaves, then this set of circumstances must be provided for in writing by the members of the partnership. These are but two of the more important reasons why, from a legal point of view if nothing else, a written partnership agreement is critical.

Practical Reasons for a Written Agreement

Perhaps the greatest single advantage of bringing the partners in a business together is to systematically go over all of the details of their business relationship. Every possible set of circumstance under which misunderstandings could arise or special decisions might have to be made can be contemplated and provided for. An example would be a situation where a partner was suddenly disabled and unable to contribute his efforts to the partnership business. Another example might be where a partner dies and arrangements have to be made with regard to the handling of his interest in the partnership vis-a-vis his estate or his beneficiaries. This can be particularly important in situations where the farmer has children who are not involved in the farm and he does not have assets outside of the farm to bequeath to them.

For farming partnerships between a father and son, it is not unusual for there to be phasing-in over a period of time of the son's profit-sharing and a corresponding reduction to the father's share of profits. A well-drawn partnership agreement must also set out the manner in which disputes and misunderstandings are to be settled.

Estate Planning Consideration

A person can do no greater favour for members of his family or other beneficiaries than by maintaining an up-to-date valid will. It is probably fair to say that for business partners, having a written partnership agreement is almost as important at the time of death as a will.

Children of a farmer who have worked on the farm over a period of years might have quite different understandings of their respective shares of the partnership income and ownership of partnership assets in the event of the death of the father. Establishing a legally valid claim in the absence of any written agreements can be rather difficult. If the father dies without leaving a will, and no written partnership agreement either, the problems can be horrendous. At times like these, family discord and even a lawsuit can arise. While a written agreement will not necessarily keep family members from arguing among themselves, it will certainly go a long way to solidify the legal positions of the various parties so that any genuine disputes can hopefully be resolved with a minimum of difficulty.

As mentioned above, estate planning becomes extremely important where there are children who are not involved in the farming business. If they are to receive part of the farming assets on the death of their parents there probably has to be a plan which provides for the purchase of the farm interests of the non-farming children over a period of time and the transaction has to be structured so the children operating the farm can afford to make the required payments. The partnership agreement and the will should provide for this plan.

In some situations, farmers leave a larger portion of their farming assets to one or more of their children because of the contribution made to the farm during the parents' lifetime. In this situation, consideration must be given to the possibility that the other children might be upset over the distribution of the estate and attempt to have the will varied.

Income Tax Aspects

We have already mentioned one or two potential tax problems that can be resolved by a written partnership agreement. An important point to keep in mind is that the profit sharing arrangements need not be spelled out in detail in the agreement if the partners do not want to commit themselves to a particular formula at the time the agreement is prepared. For legal purposes, it would be sufficient to have a clause in the agreement which stated that the profits of the business would be divided in a manner to be decided upon by the partners after the results of the fiscal period are determined. This arrangement would be sufficient to ensure that the statutory rule in the B.C. Partnership Act would not operate to cause each of the partnership members to have an equal share. It would also give the partnership flexibility as to the division of profits and enable the partners to take into account the personal circumstances of each member of the partnership in each year. Nevertheless, to avoid dispute, many partnerships may still prefer to spell out in their agreement the exact percentage of the profit to which each member of the partnership is entitled.

Sometimes the profits of a partnership are allocated in a way which provides a certain reward for time and effort (salary), a certain return on the partner's invested capital (interest), and finally a share of the net profit after deduction of the salaries and interest. The salary, interest and share of net income are all treated in the partner's individual tax returns as being part of his share of the partnership profits.

Flexibility

Members of a farming partnership should know that by entering into a written agreement they have not necessarily bound themselves by rules that are cast in stone and can never be altered. Partnership agreements are flexible, and may be varied with very little difficulty provided the partners agree on the changes. As a matter of fact, it is a good idea for a partnership agreement to be reviewed every two or three years to ensure that it still expresses the mutual understanding of the business partners, and is still adequate to handle any problems which might arise in the future.

Many partnerships fail because of poor communication and misunderstanding between the members of the partnership as to their mutual rights and obligations. A well-written partnership agreement that is reviewed regularly can go a long way to ensuring the smooth operation of the partnership business.

CHAPTER 8

ESSENTIALS OF A PARTNERSHIP AGREEMENT

Items that must be dealt with

The main purpose of a partnership agreement is to set out as clearly as possible the exact nature of the business relationship between the partners. As a minimum, a partnership agreement should include the following items:

1. The exact identity of each of the members of the partnership;

2. The legal name under which the business of the partnership is to be conducted;

3. The purpose for which the partnership has been formed;

4. The contributions of property which are to be made to the partnership by each partner;

5. The way in which profits or losses are to be divided among the partners. Note that the sharing of profits or sharing of losses need not be done on the same basis;

6. The method of accounting which is to be used to determine partnership profits or losses. Note that accounting for the partnership's income for profit sharing purposes could be done in one manner, with accounting for income tax purposes done by a different method. For example, it would be common practice to account for partnership income for profit sharing purposes on the accrual method and to account for its income for tax purposes on the cash method. If this is done, then each year a reconciliation of the results of the two methods must be prepared;

7. The level of cash withdrawals (partners' draws) which will be permitted;

8. The responsibilities of each partner to the business and his exact role in the management of the partnership;

9. The rights and duties of each partner according to partnership law and by agreement among the partners;

10. The conditions under which a dissolution of the partnership will be considered to occur as well as those circumstances which will not dissolve the partnership;

11. The method of solving disagreements among the partners.

Numerous other matters may be dealt with, but the foregoing are essential.

When the partnership is established, a detailed list of property which is being contributed to the partnership by each partner with fair market values indicated should be attached to the partnership agreement. If the values of property being contributed are to be reported at less than fair market value for income tax purposes, these special elected values should also be shown.

Since members of a partnership are not automatically entitled to any interest on their capital accounts or rental income on assets they make available to the partnership, any provision to pay for such items should be spelled out in the agreement itself.

It is very important for income tax purposes to be as clear as possible concerning the ownership of property which is used by a partnership. In some cases assets will be held directly in the name of the partnership and in other cases assets may be owned by individual partners in their own right but the use of the particular asset made available to the partnership. It should be noted that Land Title Offices in British Columbia do not accept transfer documents for registration which convey real property into the name of a partnership. Rather, it is necessary that the property be registered in the names of all of the partners of the partnership because the land registration system does not recognize a partnership as a legal entity which is able to own an interest in land. It should be clearly understood by all parties that when the partnership owns an asset, the individual partner no longer has a proprietary right to that asset. Instead, he simply has an indirect share of it by virtue of his participation in the partnership, which in turn owns the particular piece of property. These considerations are particularly important with regard to farming assets since no record of ownership may be available other than that which is agreed upon by the various parties in the partnership agreement. Ownership of grade cattle, for example, should be clearly specified to avoid misunderstandings.

Accounting for partnership income

As mentioned previously, the partnership agreement should specify that a proper accounting system be set up and maintained so that accurate financial information for the business be prepared on a timely basis. A record must be kept of each partner's personal drawings from the business and also any capital contributions he may make to the partnership. If possible, the partnership should also determine at each year-end, the adjusted cost base of each member's partnership interest so that he knows exactly where he stands for income tax purposes, in the event that he should never dispose of his partnership interest. For income tax reporting purposes as we have indicated, the members of a partnership may use the cash method even though for their own profit sharing purposes or for bank financing purposes, they may have a separate statement using the accrual method of accounting. A statement reflecting the partnership income on the cash basis should be filed with each partner's tax return and Revenue Canada has provided Form T2042 for this purpose. Revenue Canada also requires each of the partners to report the expenses they have incurred personally to earn their share of the partnership's income and to report the allocation of the net income of the partnership to the other partners. Revenue Canada has provided form T2120 for this purpose. No balance sheet is required when the cash basis is used.

Farmers who wish to report their income for tax purposes on the accrual method must prepare an income statement on that basis and also file a balance sheet with their respective income tax returns. It is important to be aware that each member of a partnership must be consistent as to the use of the cash method or the accrual method for income tax reporting. One member of the partnership cannot use the cash method if any of his partners use the accrual method.

There are a number of useful accounting packages available to farmers which can provide an excellent method of record keeping for a farming operation whether it is a proprietorship, partnership or corporation. Farmers in B.C. should consult with their local district agriculturist to determine what their accounting needs may be and how they may be best provided for.

It is imperative that the partnership have its own bank account which is separate from the personal accounts of the various partners. The partnership agreement should specify banking arrangements including signing authorities and other matters related to the operation of the account and dealing with the bank.

Management of the Partnership

Ideally, a partnership agreement should specify how the management of the business is to be carried out. In an equal partnership of two or more persons, for example, it may be necessary to provide that every decision have the agreement of each partner. In situations where there are several partners, some more senior than others, the power to make final decisions may rest with one senior partner. In such a case that partner might be designated in the agreement as the "General Manager", and the extent of his powers and obligations would be clearly spelled out. Some farmers carrying on business in partnerships might wish to specify that certain management functions are the responsibility of another partner. It is sufficient to say that this is an area which is completely flexible and can be set up in any manner whatsoever so long as it reflects exactly what the partners want to do.

The rights and duties of each partner should be clearly identified and understood by each member of the partnership. According to partnership law, for example, each partner has:

a) the right to make contracts;

b) the right to undertake individual obligations; and

c) the right to participate in the management of the business.

Once again it is important to be aware of that unless the partnership agreement specifies otherwise, then every member of the partnership has an equal right to participate in the management and operation of the partnership's business. For this reason, if for no other, it is often very useful to set forth the management responsibilities in the partnership

agreement. Sometimes this is done on a basis similar to that which might apply in a limited company. That is, a senior partner might have 60 votes and two junior partners might have 20 votes each. As in the case of a limited company this would give the senior person control of the conduct of the business.

Members of a farming partnership should be aware that if one partner enters into a contract and incurs a debt on behalf of the partnership business, then each partner is liable for that debt and the creditor may have recourse to the personal assets of each individual partner in order to collect the amount which is due. A partnership thus has unlimited liability in that the personal assets of the partners are at risk depending upon the actions taken in the partnership business itself. Some measure of protection can be afforded by such means as liability insurance, and due care and prudence in business dealings, a characteristic which most successful farmers will already possess in considerable measure.

CHAPTER 9

SELECTION OF A FISCAL YEAR-END FOR A PARTNERSHIP

A fundamental concept of our income tax law is that the taxation year of every individual taxpayer is the calendar year. Generally, all the incomes or losses that an individual realizes in a particular calendar year are taxable in that year. Business income is an exception, however, because it is taxable in the calendar year in which the individual's fiscal period ends.

When an individual commences a new business he can establish his first year-end at any date within the next twelve months. Once that year-end is established it must be followed consistently and can be changed. These rules also apply to partnerships.

If the first fiscal period, or any subsequent period, is less than 365 days, the claim for capital cost allowance on depreciable assets owned by the business must be pro-rated according to the following formula:

$$\frac{\text{Number of days in fiscal period}}{365} \times \text{Normal capital cost allowance claim}$$

An important exception to the above rule is the write-off available for assets which qualify as eligible capital expenditures, such as milk quota or poultry quota. The normal depreciation can be claimed on these assets even though the fiscal period is less than 365 days.

This can be illustrated as follows:

a) Milk quota acquired by a partnership on commencement of the business at a cost of $ 100,000

b) Amount which can be treated as an eligible capital expenditure and can be written off for tax purposes $ 50,000

c) Amount available as a write-off in the initial fiscal period of the partnership

10% x $50,000 = $ 5,000

If a farming partnership carries on a dairy operation, the write-off in respect of quota in the first fiscal period can be significant.

When individuals commence a new partnership they will generally be able to wait until April of the year following the year in which the partnership is formed before deciding the date of their fiscal year-end. If the partners have no other income in the calendar year in which they commence their new business, it may be appropriate to choose a fiscal period that ends in that calendar year and produces a net income that is approximately equal to the amount the partners can claim in respect of personal exemptions and other

deductions. If, on the other hand, the partners have sufficient other income to absorb their personal exemptions and deductions it may be appropriate to allow the first fiscal period to run for a full twelve months or to run to a date in the next calendar year. By doing this, the partners will be able to defer for twelve months the due date for the payment of tax on the profits of their first accounting period.

Assume for instance that a partnership commences business on June 1, 1983 and that the partners have sufficient non-business income in calendar 1983 to absorb their personal exemptions and deductions. Assume also that the partnership is profitable from the outset. In these circumstances, the partnership would almost certainly decide to have its first fiscal period end in 1984 so that the taxes payable in respect of that period could be deferred to April 1985. The partnership could allow the period to run to May 31, 1984 but, depending on the facts, it would probably be advisable to cut it off at the end of January 1984. This would have the effect of pushing the profits for the months of February to May 1984 into the fiscal period ending January 31, 1985 and would defer the tax on those profits from April 1985 to April 1986.

The income tax consequences which arise when a partnership terminates are also worth noting. When a partnership ceases to exist, either by operation of law or by one of the special provisions of the Income Tax Act, its fiscal period will be considered to end immediately before that time. This can result in a situation where more than twelve months of business income is taxable in one year. Here is an example of how that might happen:

a) a partnership has a fiscal year-end of January 31;

b) on December 31, one of the partners withdraws from the partnership causing the partnership to terminate;

c) because the income reported as of January 31 of that year represents twelve months' income from the partnership and because the income for the period February 1 to December 31 of that year represents another eleven months, a total of twenty-three months of income becomes taxable in that calendar year.

Fortunately, there is a provision in the partnership rules which allow an individual partner who is a member of a partnership in the above circumstances to defer the reporting of the income for the eleven month fiscal period to the normal year-end date which would be January 31 of the next calendar year. This special election must be made by each individual partner, not by the partnership itself. The result would be to move into the next calendar year the tax burden on the eleven months of extra income. This would give the individual partner a chance to arrange his affairs for that next calendar year so that he did not suffer an unduly harsh tax burden. The same advantage is available to a sole proprietor in similar circumstances, who might otherwise be forced to pay income tax on more than twelve months' income in the year that his proprietorship ceases.

CHAPTER 10

HOBBY FARMERS CARRYING ON A FARM BUSINESS PARTNERSHIP

As mentioned in Chapter 5, when a partnership which carries on a farming business determines its income for tax purposes, the restrictive rules concerning hobby farmers, in Sections 31 and 111 of the Income Tax Act do not apply. These rules come into play only when each member of the partnership reports his share of the partnership income or loss for tax purposes. Reference should be made to "Taxation and the B.C. Farmer", Chapter 12, or to Interpretation Bulletin No. IT-322R for a full review of the income tax rules concerning hobby farmers.

In essence, a member of a farming partnership will be subject to the special rules in Section 31 of the Income Tax Act where it is determined that his chief source of income is neither from farming nor a combination of farming and some other source. In making this determination the extent of the partnership's farming activities is not a critical factor. The most important consideration is whether the individual's way of life is that of a farmer and whether he pursues his farming business in a manner that will enable him to earn his livelyhood from it.

It is important to note than an individual will not even be allowed the restricted loss that is available under section 31 of the Income Tax Act if the farming venture is such that it cannot be expected to generate a profit. In that situation, the venture is not treated as a business and all expenses are treated as being personal in nature.

Many of the special income tax advantages which are available to bona-fide or full-time farmers are also available to hobby farmers. The following is a list of some of them:

a) Use of the cash method of calculating income from the farming business and use of the livestock inventory rule;

b) Use of the special $1,000 per year exemption for gains on a principal residence situated on a farm;

c) Use of the 7% or 10% investment tax credit for acquisition of certain prescribed machinery and equipment or prescribed buildings used in a farming business or qualifying transportation equipment;

d) Use of the farm rollover in respect of a transfer of farm property or an interest in a farming partnership to a child during the lifetime of the farmer or on his death;

e) Deduction for clearing and levelling land and laying tile drainage.

This deductible expense is available to a farming partnership consisting of hobby farmers in the same manner as it would be to any other farming business.

CHAPTER 11

TRANSFERS OF PROPERTY TO A CANADIAN PARTNERSHIP

General rules for contributing or selling assets to a partnership

When a person transfers property of any kind to a partnership, the transaction must take place at fair market value for income tax purposes. If the partnership does not pay fair value for the assets it acquires, the income tax rules will nevertheless deem the partner to have received fair market value for them. Similarly, the partnership will be considered to have acquired the property at fair market value. The individual partner who transferred the property to the partnership will be taxable on the capital gain, recapture of capital cost allowance or other taxable income arising on the transaction.

This general rule will not apply if the person making the transfer becomes a partner in the partnership and a special election is filed with Revenue Canada. This election is described below.

If property is transferred from the partnership to an individual partner the transaction must be reported for tax purposes at fair market value unless a specific rollover provision applies.

The partnership rollover - a tax deferral can be achieved

If there was no relief from the effect of the foregoing rules, then the initial formation and reorganization of partnerships could be very expensive in terms of income tax. As a result, the law allows a special election to be made, in certain cases, which will permit an income tax deferral when property is transferred to a partnership. Deferrals can also be obtained in certain other cases where partnerships are reorganized.

The most commonly used rollover provision in the partnership rules is for transferring property to a partnership. The details of this rule are worth close examination. In essence, they provide a way for virtually any kind of property owned personally by a partner to be transferred to a partnership business. Here are the specific tests, set out in subsection 97(2) of the Income Tax Act, which must be met:

a) The transfer of property must take place after 1971;

b) The partnership involved must be a Canadian partnership. A Canadian partnership is defined as one in which all of the members are residents of Canada;

c) The transfer in question must involve an acquisition of property by the partnership. The term "property" for this purpose has a very broad meaning.

It includes property, in the normal sense of the word, of any kind whatsoever, whether tangible or intangible. It includes all depreciable property. It also includes government rights, inventory and accounts receivable including assets of that nature which are owned by a farmer who reports his income on the cash basis. Land inventories are also included;

d) The taxpayer who transfers the property must be a member of the partnership immediately after the date of the transfer. Note that this member could be an individual taxpayer or a corporate taxpayer. In rare circumstances, it could also be another partnership;

e) All of the persons who immediately after the transfer are members of the partnership must jointly elect with respect to that property, to have the rollover rules in subsection 97(2) of the Income Tax Act apply;

f) The deadline for filing this election is the earliest date on which any party to the election is required to file a tax return for the year in which the transaction occurs. In certain situations elections can be filed late with the payment of a penalty;

g) The prescribed form for the election is Form T2059. It is available from any District Taxation Office;

h) If capital losses exist on the property being transferred, some special restrictions may apply as to the use of such losses.

If all of the foregoing tests are met, the property in question can be transferred to the partnership for tax purposes at amounts that are less than fair market value. The whole purpose of the election, of course, is to ensure that the property can move from the partner to the partnership without any income tax arising. The elected amount will be considered to be the amount of the proceeds received by the partner, as well as the cost for which the partnership has acquired the property. An election cannot be made for a value greater than the fair market value of the property. On the other hand, the elected amount cannot be lower than the consideration (other than an interest in the partnership) received by the taxpayer for the property.

If the elected amount exceeds the consideration (other than an interest in the partnership) the amount of that excess is added to the adjusted cost base of the member's interest in the partnership.

Example of how the partnership rollover works

The mechanics outlined above may be somewhat confusing to the layman. Here is an example of how an individual member of a partnership might transfer a parcel of farm land which has appreciated in value to the partnership business using the rollover rule.

It is assumed at all times that the farm land is a capital property of the person who is transferring it.

Original cost of land 1962	$ 20,000
V-day value of land December 31, 1971	$ 100,000
Fair market value of land at date of transfer June, 1983	$ 220,000
Amount of capital gain which would be realized if the transfer were made at fair market value	$ 120,000
Taxable one-half of the above gain	$ 60,000
Amount of the potential income tax liability, assuming a personal tax rate of 50%.	
50% x $60,000 =	$ 30,000

The individual who owns the land described above is not presently a member of the partnership but is being invited to join the partnership and to contribute his land in exchange for an interest in the partnership. There are two members of the existing partnership each of whom has a one-half interest. After the transaction takes place, each of the three partners will have a one-third interest in the partnership. Here is a suggestion as to how the transaction could be structured:

a) The partnership would agree to give the incoming partner a promissory note or mortgage equal to $100,000. This amount equals the V-day value of the land;

b) The partnership would also agree to give the incoming partner a one-third interest in the partnership. For commercial purposes, this one-third interest would be considered to have a value of $120,000. The total commercial value of the consideration given up by the partnership therefore, would be $220,000;

c) In preparing the T2059 election form, however, the partners would elect to show the value of the land at $100,000 for tax purposes;

d) In the partnership agreement, the partners would agree that in the event the land was sold, the accrued gain at the date of transfer ($120,000) would for tax purposes be allocated to the new partner, or to the person who subsequently acquires the partnership interest of the new partner. This agreement would be required so that the existing partners are not subject to tax in the future on a gain that accrued before the partnership acquired the land.

The result of the above transaction would be that the individual partner who transferred the land would have disposed of it at a value equal to its adjusted cost base for income tax purposes. He would not have to recognize a capital gain at the time of the transfer. Similarly, the partnership would have acquired an asset with an adjusted cost base of $100,000. If and when that land is sold, the partnership would realize a capital gain calculated by reference to that adjusted cost base. The first $120,000 of that gain would for tax purposes be allocated to the new partner and any additional gain would be allocated equally between all the partners. The original owner of the land would have a one-third partnership interest with an adjusted cost base equal to Nil. If he were to sell his partnerhip interest soon after this transaction for $120,000, he would realize a capital gain of $120,000. This is the gain which had been deferred when he originally transferred the land to the partnership.

Isn't that double taxation?

If we pause at this point it might seem that we have created a situation for double taxation. Here's why. The new partner who put the land into the partnership has now sold his partnership interest and realized a capital gain equal to the gain on the land which he had formerly owned. As well, the partnership still holds an asset with a fair market value of $220,000 but with an adjusted cost base of only $100,000. When the partnership sells that asset, an additional capital gain of $120,000 will be realized.

Aren't we being taxed twice on the same thing? The answer to that question is yes but ultimately the double tax will be removed when the partnership is wound-up and the partners realize a capital loss of $120,000 on the disposition of their partnership interests.

As mentioned above, we are assuming that the new partner (who we will call Mr. C) sells his partnership interest to Mr. D. for $120,000. We are also assuming that the partnership sells the land to a third party for $220,000 and realizes a capital gain of $120,000. As a result of the partnership agreement, the capital gain for tax purposes is allocated to the new partner (Mr. D). In other words, he has to pay tax on the income that arises for tax purposes.

As noted in Chapter 6, the capital gain determined at the partnership level is reduced by one-half to determine the taxable capital gain, and it is this amount ($60,000) which is included in the new partner's (Mr. D's) income. This taxable gain, together with the new partner's share of other taxable income arising in the year the land is sold, will be added to the adjusted cost base of his partnership interest. A further addition of $60,000 will be made to the adjusted cost base of his interest in respect of the non-taxable portion of the capital gain.

If we look at Mr. D's tax position we see the following.

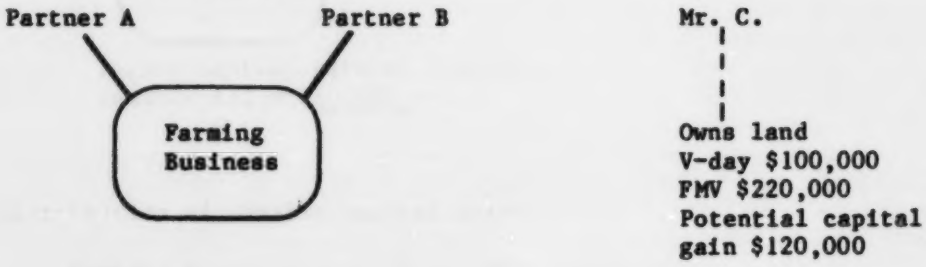
Allocation of taxable income from partnership

Taxable capital gain		$ 60,000
Adjusted cost base of partnership interest		
Initial cost	$ 120,000	
Addition for taxable gain	60,000	
Addition for non-taxable gain	60,000	
	240,000	
Share of underlying assets in the partnership	120,000	
Potential future capital loss on wind-up	120,000	
Potential future allowable capital loss 120,000 x 1/2		(60,000)
Net position		Flat

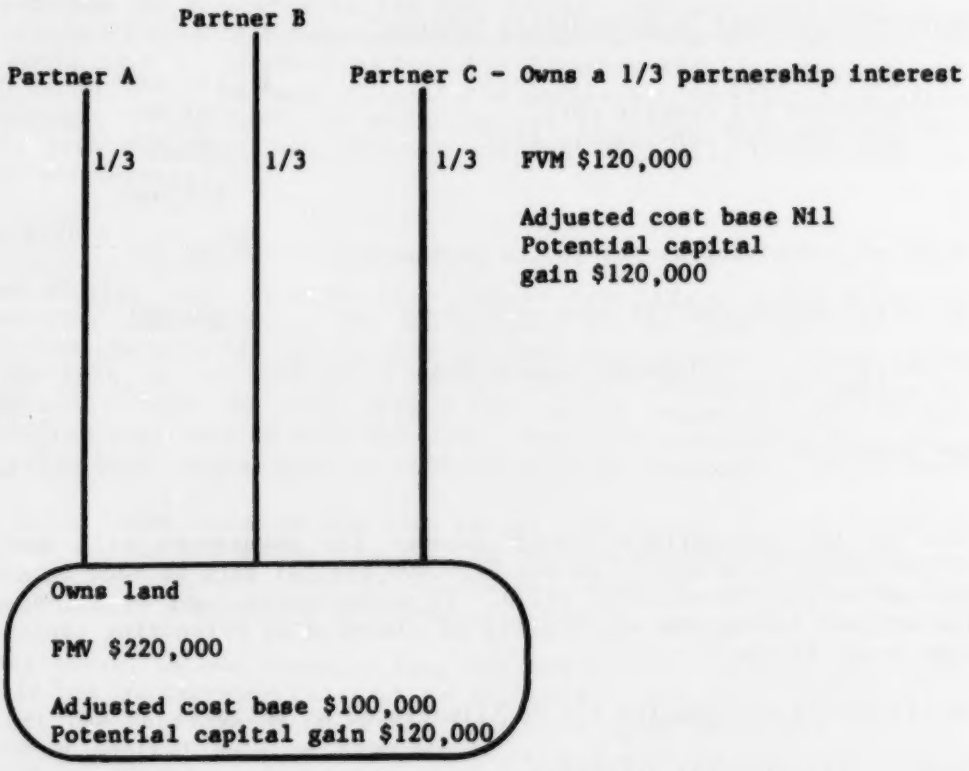
This is the appropriate result because the government will have already collected tax from Mr. C. on the $120,000 capital gain he made on the sale of his partnership interest to Mr. D. It would not be fair if Mr. D. also paid tax without having the opportunity of claiming an offsetting capital loss at some point in the future.

The foregoing explanation can be illustrated as follows:

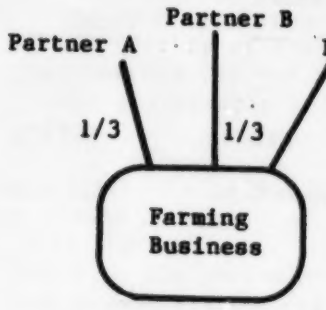
Step 1 - the original situation



Step 2 - The land is transferred to the partnership on a rollover basis



Step 3 - Partner C sells his partnership interest to Partner D



Owns one-third partnership interest

Adjusted cost base $120,000

Ex-partner C

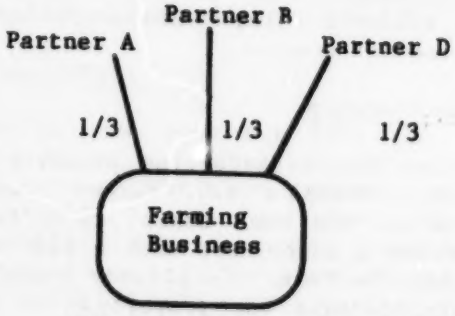
Incurs capital gain of $120,000 on sale of partnership interest

Taxable 1/2 = $60,000

Owns land

FMV $220,000
Adjusted cost base $100,000
Potential capital gain $120,000

Step 4 - The partnership sells the land to a third party



Incurs capital gain of $120,000
Taxable 1/2 = $60,000

Distribution of taxable capital gain:

Partner A	$ NIL
Partner B	NIL
Partner D	60,000

Distribution of cash

Repay note to C	100,000

Addition to adjusted cost base as a result of the sales:

	Taxable Gain	Non-Taxable Gain	Total
Partner A	$ NIL	$ NIL	$ NIL
Partner B	NIL	NIL	NIL
Partner D	60,000	60,000	120,000

It's complicated, but it's usually advantageous

We have gone through the above exercise in detail to illustrate the point that ultimately double taxation does not occur as a result of a transfer of property to a partnership using the rules under subsection 97(2). Significant timing difficulties may occur, however. One possible downside risk, is that individual partners may be left with substantial allowable capital losses when they dispose of their partnership interests which cannot be utilized fully in the year the interests are sold. (Mr. D may have been in this position in our example). In the majority of situations, however, this is not generally a problem. The ability to transfer property to a partnership on a tax-deferred basis is a distinct advantage which should be sought out whenever possible.

There may be some situations where ordinary income may be converted to a capital gain as a result of using the rollover rules. Discussion of this possibility is beyond the scope of this booklet however.

Transfer of cash basis properties to a partnership

Before we leave the subject of the rules for transferring property to a partnership, let us consider a situation where a B.C. farmer transfers inventory, which he has always reported on the cash basis, to a farming partnership. Let us say that the farmer has a dairy herd with a fair market value of $75,000. In this particular case the farmer is already a member of the partnership to which he will be transferring the property. A common example might be a father-son farming partnership which was set up as a way to bring the son into the business. The point in time has now arrived where father feels confident enough to transfer the full value of the dairy herd into the partnership which he operates on a 50-50 basis with his son. In reporting his income for tax purposes, the father has always used the cash method with regard to all of his farming operations. As a result, the dairy herd does not shown up on his balance sheet. If the father were to sell the herd on the open market he would receive $75,000 cash all of which, for tax purposes, would be taxable income to him from the disposition of inventory. In making an election to use the partnership rollover, he and his son can jointly elect as follows:

a) The cash consideration given to the father by the partnership for the dairy herd will be $1;

b) The interest in the partnership given to the father for the balance of consideration due to him for the herd, would be the right to receive $75,000 of the partnership's profits at a rate of $15,000 per year over the next five years. In sharing the profits of the partnership at the end of a particular fiscal year, the father first takes his $15,000 for the inventory for that year and the balance of the partnership's profits are then split 50-50 between father and son.

Let us vary the facts a little bit and pre-suppose that the father has some farming losses from past years or other deductions available to him that he would like to utilize. Let's say that in the year that the herd is transferred to the partnership the father has accumulated farming losses and other deductions available in the amount of $30,000. In this case the father and son would probably elect to transfer the herd at $30,000 and in the year of the transfer the father would have to take this amount into his income. He would not pay any tax however, because the $30,000 would simply offset the losses and other deductions available. The father would then be able to withdraw $30,000 from the partnership without being subject to tax. The balance of the inventory price, being $45,000, could be distributed to him in profits of the partnership over a five year period, perhaps at $9,000 per year.

We have assumed in this illustration that the father would accept an increased share of future profits in exchange for the transfer of his herd to the partnership. As an alternative, his capital account might be increased by the fair market value of the herd.

Terminal Losses

New rules have been put into the Income Tax Act which will prevent an individual (or a corporation) from claiming a terminal loss arising from the transfer of depreciable property to a partnership, if the individual (or corporation) is a "majority interest partner" (as defined) of the partnership. If a "majority interest partner" transfers only some of the property of a particular class to the partnership, these same rules can alter the proceeds of sale to the partner and the cost to the partnership.

Summary

We hope that the above examples have illustrated the mechanics of the rollover rules which apply when a taxpayer transfers property to a Canadian partnership. It cannot be emphasized too strongly that these rollover rules can be very useful when a partnership is being set up. It is also advantageous where a new partner is transferring property to an existing partnership.

CHAPTER 12

OTHER ROLLOVER RULES AVAILABLE FOR PARTNERSHIPS

We have discussed at some length the rules regarding transfers of property to a partnership, because these rules are extremely important when persons set up a farming partnership in B.C. Members of a partnership should always be aware, however, that other types of tax rollovers may also be available for certain types of reorganizations or property transfers involving partnerships. Income tax may be deferred in these circumstances as well. The following is a summary of the more important of these other types of rollovers:

1. Dissolution of a Canadian partnership and the transfer of the partnership property to the various member partners

   The rules applying to this rollover are contained in subsection 98(3) of the Income Tax Act. The rules apply only to a Canadian partnership that distributes all of its property to its partners and then ceases to exist. The distribution must be carried out so that each partner acquires an individed interest in the assets so distributed. A partner's percentage of ownership in any particular property distributed by the partnership must be equal to his percentage ownership in all other partnership properties. A special election must be filed with Revenue Canada by each of the partners in order for the rollover to apply.

   The exact details of this rollover rule are beyond the scope of this booklet, but it should be pointed out that if a partnership is going to be dissolved, careful calculations should be made beforehand. If the rollover rule is not used, the partnership's property will be treated as having been disposed of at fair market value and income tax may apply as a result.

2. Changing a partnership into a limited company

   In a situation where the members of a partnership wish to incorporate their business, a special rule exists in subsection 85(2) of the Income Tax Act which allows certain types of partnership property to be transferred to a corporation on a rollover basis. This rule is more restrictive than the rollover rules applying to property transferred by an individual to a partnership. For example, real estate held for resale can be transferred to a partnership on a tax-deferred basis under subsection 97(2) of the Act but cannot be transferred by a partnership to a corporation on a rollover basis.

   Generally it is possible to designate the transfer price to be any amount between the value of the consideration received by the partnership, other than shares in the corporation, and the fair market value of the property being transferred to the company.

3. Where one Canadian partnership has been discontinued, and a new partnership takes its place.

In a situation where one partnership ceases business and a new partnership is formed to carry on, a rollover will be permitted if all of the members of the new partnership were also members of the partnership which has discontinued its business. This rollover is permitted by subsection 98(6) of the Act. A common example of this might be in the situation where three people are members of a partnership and one person decides to leave the partnership. By operation of existing law, subject to any express written agreement to the contrary, the partnership would be considered to cease to exist. A new partnership might then be formed between the two remaining partners, to carry on the same business. (In most cases it will be advantageous in the written partnership agreement to have a clause which states that the partnership does not terminate in the event of the withdrawal of a member. If that is the case, then the partnership will be deemed to continue and the use of this rollover rule may not be necessary.)

4. Where a Canadian partnership has been discontinued and property owned by the partnership has been transferred to a sole proprietor who was a former member of that partnership

Under subsection 98(5) of the Act, where a partnership breaks up and one of the former members of that partnership takes property from the old firm and continues to carry on the business formerly operated by the partnership, a special rollover may also be permitted. A common example might be where two partners have a falling out and one of them goes his separate way leaving the remaining partner to carry on the business as a proprietorship. This rule will apply automatically without the necessity of any special election, provided certain criteria are met. The partnership must have ceased to exist after 1971 and it must have been a Canadian partnership. Within three months of the discontinuance of the partnership, the sole proprietor must carry on the partnership's business. It is not necessary that all of the property of the former partnership be used by the sole proprietor in carrying on that business.

CHAPTER 13

SALE OF THE FAMILY FARM

It is beyond the scope of this booklet to discuss all the matters which should be considered if a family farm partnership contemplates the sale of its farm. The one important point that should be noted at this time, however, is that it is now more important than ever to seek advice before the sale takes place. Preferably this advice should be sought one or two years before the farm is sold.

In the past, if a farming proprietorship or partnership sold its farm without giving too much consideration to the consequences, the farmer usually managed to avoid serious tax problems by taking advantage of the general averaging or block averaging rules in the Income Tax Act or by purchasing an income-averaging annuity contract to defer the taxes that were payable. Unfortunately, the general averaging rules are no longer available and it is no longer possible to purchase an income-averaging annuity contract. These tax saving devices have been replaced by a new form of averaging called "forward averaging" but it is not as beneficial to taxpayers.

Another factor which could have an adverse impact on a partnership selling its farm is the recent "tightening-up" of a farmer's ability to spread his tax liability over the period in which he receives the sale proceeds. Occasionally, farmers will now be put in the unfortunate position of having to pay tax on amounts they have not received.

It should be noted that an amendment was made to the Income Tax Act recently that will restrict the ability of a farmer to deduct a terminal loss arising on the sale of farm buildings if the land on which the buildings are situated are sold at a profit.

While not conclusive, the following matters should be considered by a family partnership prior to the sale of its farming business:

1) The purchase of replacement farming properties which will have the effect of deferring tax from the sale of the original farm;

2) The possibility of selling the farm assets over two years to defer tax arising from the sale;

3) The transfer of partnership interests to children;

4) The ability of each partner to use block averaging in the year of sale;

5) The allocation of the sale proceeds between the various assets being sold so as to maximize the partners' tax positions;

6) The cash that will be available to enable the partners to discharge their tax liabilities;

7) The benefit that will be obtained from forward averaging; and

8) Income-splitting techniques after the sale.

APPENDIX 1

NINE IMPORTANT PRINCIPLES

THE BUSINESS AND HUMAN SIDE OF

MAKING FATHER-SON AGREEMENTS WORK

Both parents and young people are interested in ways to help the younger generation get started in farming. The kinds of arrangements being used are many. No two are exactly alike. Families have different objectives; different resources are involved; and the relative contribution that each party makes is unique to each family situation.

There are certain principles, however, that need to be recognized in every family agreement. The principles involved are economic and psychological. Failure to recognize and abide by these principles can, and often does, result in short-lived, disappointing experiences which sometimes leave bitter memories. In no particular order of priority, here are some of the important principles:

1. Mutual regard for the opinions of others. Families need to recognize that when two or more people are involved in a business on some basis other than an employer-employee relationship, the business independence of the various individuals is limited.

   Important business decisions usually need to be made jointly. Compromises may have to be made and "I told you so" attitudes must be suppressed. Differences of opinion need to be discussed freely and thoroughly, but each person must try to understand and respect the point of view held by others.

2. Decision-making should be shared. One of the hardest things for a father to do when he enters into a father-son operating agreement may be to give up his right to make independent management decisions. The son needs to learn the processes of decision-making and he needs the opportunity to practice these skills with Dad's help. The father's years of experience and the ideas the son may bring from 4-H, extension meetings or college need to be blended.

   This can be done by thinking through problems and ideas together. Talk about the problems and things that might be done to improve the operation. Take advantage of the ideas and thoughts that all parties involved can contribute. You may want to check tentative decisions against the thinking and experience of others who may already have tried the idea.

   If agreement can't be reached on major decisions, compromises may have to be made. Son or Dad may have to say "Okay, we'll do it your way." And if the idea doesn't work out, you may have to run another "play". A different "ball carrier", may or may not be called for. Remember, it's a team effort. In those instances where complete agreement can't be reached and one or the other has to "give in," the "giving in" shouldn't always be done by the same person.

If the skills and interest of father and son are different, there may be an opportunity to capitalize on these differences. People usually do best at the things they like to do. Consequently, the entire business may benefit by assigning major responsibilities for management decisions and work on this basis.

3. Potential for sufficient income. The business must be large enough to produce enough money to satisfy the needs of all the families involved. No working agreement, regardless of how carefully it may have been designed will make up for lack of adequate income.

   If the business isn't large enough to support two (or more) families, what are the possibilities for increasing the size of the business? Is it practical to consider buying more land? If not, can more land be rented? What are the possibilities for adding some kind of livestock enterprise or enlarging one that is already on the place?

   Some "pencil pushing" to see how much income would be available to each family on a continuing basis should be done before the decision is made to set up a children-parent operation. Projected cash flows should help size up the income potential for the farm as a whole and for each of the partners involved.

4. Equitable sharing of income. Income should be divided on a business-like basis. There are several ways this can be done. One widely accepted principle of sharing the income from joint business endeavours is to share all the income in the same proportion as each party contributes to the business or enterprise. If this method of dividing the income is to be used, it is necessary for father and son to list the contributions that each will make and to place values on those contributions that are mutually acceptable. This will enable them to determine what proportion of the total contributions will be made by each of the participating parties, and at the same time, give them a basis for dividing income that may be realized.

   Since the parents frequently own the land, they may prefer to rent the land on regular leasing terms to the joint tenant made up of father and son. In this case, the father would be "wearing two hats" - one as the landlord, and one as a tenant. The advantage of this method is that it establishes a return to land and eliminates the need for setting a value on the land contribution - something that is sometimes difficult to do in view of present day land values, high interest rates, and increasing property taxes. The tenant income would be divided between father and son in proportion to the contributions that each makes to the tenant's portion of the business.

   Still another way that income could be divided is to agree on an acceptable return which will be paid for land, breeding livestock, machinery, and labour. This should be done with the understanding that any income not allocated on this basis would be split equally between father and the participating son.

5. Son's share of net income must be satisfactory. If the income is to be shared in proportion to contributions made by father and son, it is

important that the son's share of the contribution be large enough to entitle him to sufficient income to meet his needs. This means enough to enable him to grow financially as well as to take care of his family living expenses.

Many sons have little to contribute to the business except their own labour and some management ability. These alone would probably not make up more than 10% to 15% of the total contributions required and, therefore, would entitle him to only a small portion of the net income. Consequently, some ways need to be worked out for the son to increase his contributions.

One possibility would be for the son to take over all or part of the machinery contribution. He might buy part or all of the machinery from Dad on an installment contract basis or he might rent it from Dad. The latter might be the better alternative during the first few years until it becomes certain that the operating arrangement is going to survive. Dad will probably have to help the son get needed operating capital also, by co-signing notes.

6. People involved must be able to "get along." If a two-generation family operating agreement is really going to work, the persons involved must be able to get along with each other. Not only must father and son be able to work with each other, but the wives must be compatible also.

   When you're thinking about forming a father-son operation of some kind, it should be recognized by both generations that such a relationship is quite different than the one which existed when son was growing up and Dad was making all of the decisions. Son is likely to have some ideas he'd like to try that Dad isn't going to approve of. Can you work out the differences and still be on speaking terms? If you can't, then possibly you shouldn't even consider working together.

   If there is any question in your minds relative to this point, it might be well to consider the possibility of making the first few years a sort of "trial run" period.

   During this time, irreversible commitments on the part of either the father or the son should be avoided if at all possible. If more machinery is needed, you might want to consider renting instead of buying. You might even want to think of operating on an employer-employee basis during this time - but with one important stipulation! During this time, Dad should make it a point to involve the son in decision-making. Find out how well you can talk problems over and resolve differences.

7. Good communication is important. Good communications between all parties involved is important. Father and son need to discuss their thoughts and concerns about the business openly and completely. If you have complaints about the way things are being done, get your feeling out in the open. If dissatisfactions are bottled up, there's a real danger that they might explode some day and blow the whole business apart!

It's a good idea to have the overall plan of operation in writing. The written agreement shouldn't be thought of as a legal club to be held over the other person's head, but as a reminder to father and son and as a guide to heirs should death take either the father or son, or both.

It isn't enough to have good communications between just the father and son. The wives and brothers and sisters should be kept informed of what is being done and what is planned.

8. Living arrangements a potential problem. If the son is not married when he first enters into the joint operation of the farm or ranch, he may want to continue to live at home. If he does, he probably should pay the folks for his board, room, and laundry. Not all families will see it this way, but remember, Mom isn't as young as she used to be and other children who may be working in town and paying their own way may feel they are being discriminated against.

   If the son is married, separate housing is a must. It may even be desirable to have the houses more than just a few hundred feet apart. The young couple should be careful not to let their children outwear their welcome at Grandma's house. Grandchildren are nice to have, but grandparents shouldn't be made full-time babysitters. Too intimate and constant association between grandparents and grandchildren increases the likelihood that grandparents will become critical of the way the grandchildren are being raised or that grandparents will become too bossy.

   Generally, it's best if the personal living of both families can be kept out of the business as much as possible. Critical thoughts about what the other family does or doesn't do probably should be left unsaid in most instances.

9. Long range planning needed. Before the father-son operating agreement has gone on too long, some consideration needs to be given to estate planning on the part of the older generation. Once the parents have worked out their estate planning objectives, they should find a good attorney to help them develop a good plan for carrying out these objectives.

   Particularly important is the ultimate disposition of the farm. The son who is working with the father needs to have some basis for making plans for his future. Will part of the farm go to other brothers and sisters? Will he have a chance to buy their share of the land? Parents may want to consider selling part or all of the farm to the son who is farming with Dad. Such a sale would probably have to be on a long-term installment contract basis. Life-time gifting of part or all of the land to children should also be considered. This could be done in one of several ways over a period of years.

   If the son wants to put any kind of permanent improvements on the father's land, there should be an agreement in writing which would give the son the right to recover the undepreciated value of such improvements.

APPENDIX 2

1983 FEDERAL BUDGET PROPOSALS OF PARTICULAR INTEREST TO FARMERS

On April 19, 1983, the federal government tabled its 1983 budget in the House of Commons. This budget came on the heels of the enactment of the November 12, 1981 and June 30, 1982 federal budgets which, after considerable delay, were passed into law on March 30, 1983.

Summarized below are the proposals in this budget which are of particular interest to farmers. It should be noted that they are not yet law and could be amended by parliament.

1. The Income Tax Act (the Act) now permits a farmer to transfer shares in a farming corporation to his children on a "rollover basis". These rules are discussed in chapters 13 and 14. The government now proposes that the rules be broadened so that a "rollover" can be obtained on the transfer of shares of a family farm holding corporation. This change is to be made effective for transfers after May 25, 1978, which is the date on which the farm corporation rollover rules were put into the Act.

2. The government has proposed that the loss carry-over rules be liberalized. Under these proposals, the farm losses of an individual, partnership or corporation (including restricted farm losses - see chapter 12) may be carried back three years instead of one, and carried forward for ten years instead of five. In most situations, these new rules will apply to losses for the 1983 and subsequent taxation years.

   The rules dealing with the carry back of net capital losses are to be changed also. It is proposed that net capital losses incurred in 1984 may be claimed against net capital gains earned in the 1982 and 1983 taxation years. Net capital losses incurred in 1985 and subsequent years may be carried back three years. Individuals who incur capital losses in 1984 may apply up to $2,000 of the allowable loss against any income earned in 1982, 1983 and 1984. At present, net capital losses may be carried back only one year.

   Rules are to be introduced that will restrict the deduction of farm losses by a corporation where there is a change in control.

3. The government has proposed a number of changes to the investment tax credit rules (see chapter 8). The highlights of these changes are as follows:

   - Credits arising from eligible investments made after April 19, 1983 may be applied against federal taxes payable without regard to the limits that apply currently (see page 38). The carry-forward period for these credits is to be increased from five years to seven years.

- Credits earned after April 19, 1983 may be carried back for three years to reduce federal tax in those years. This measure is to be phased in over the 1983 and 1984 taxation years.

- A portion of the credits earned on eligible investments made after April 19, 1983 and before May 1, 1986 will be refunded directly in cash to taxpayers who could not otherwise fully use their credit to reduce their federal tax. Individual farmers and farm corporations eligible for the low rate of tax will be able to obtain a cash refund in any particular year of 40% of the unused credits earned in that year.

- The government has proposed a novel concept under which corporations can use tax credits earned on the purchase of new assets to attract purchasers of new common share equity. Under this concept, corporations will be allowed to issue shares which will entitle the first purchaser to a tax credit of up to 25% of the issue price paid. Share purchase tax credits claimed by share purchasers will reduce the amount of the tax credits available to the corporation. Only credits earned after April 19, 1983 will be eligible to be transferred to purchasers of new shares. This proposal will probably not be of much interest to the average family farm.

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